

INTRODUCTION

On Wednesday, November 5, 2003, the Assembly Committee on Revenue and Taxation and the Assembly Jobs, Economic Development, and the Economy Committee held a joint informational hearing to review tax expenditures (TEPs). The hearing was held in Room 126 of the State Capitol in Sacramento, California from approximately 1:30 p.m. until approximately 3:30 p.m. Approximately fifty people attended the hearing.

Four Assemblymembers heard testimony from twelve witnesses. Members who participated in the hearing included:

Assemblymember Ed Chavez, Chair, Revenue and Taxation Committee
Assemblymember Mark Ridley-Thomas, Chair, Jobs, Economic Development,
and the Economy Committee
Assemblymember Bonnie Garcia, Vice-Chair, Jobs, Economic Development, and
the Economy Committee
Assemblymember Jennie Oropenza, Chair, Budget Committee

This final report contains the committee staffs' summary of the testimony offered and conclusions reached during the hearing. The report also reprints the background paper written by staff before the hearing (refer to blue pages) and reproduces written testimony and documents submitted by the witnesses (refer to yellow pages).

THE WITNESSES

Ms. Betty Yee, Chief Deputy to Board of Equalization Chairwoman Carole Migden

Dr. Mark Ibele, Principal Fiscal and Policy Analyst, Legislative Analyst's Office*

Ms. Pat Landingham, Assistant Program Budget Manager, Department of Finance

Dr. Phil Spilberg, Director, Economic & Statistical Research Bureau, Franchise Tax Board

Mr. Dave Hayes, Manager, Research & Statistics Section, State Board of Equalization

Mr. Fred Silva, Senior Advisor, Governmental Relations, Public Policy Institute of California

Dr. Rob Wassmer, Professor, Public Policy and Economics, California State University - Sacramento*

Mr. Greg Turner, General Counsel and Legislative Director, California Taxpayers Association

Mr. Lenny Goldberg, Executive Director, California Tax Reform Association

Ms. Jean Ross, Executive Director, California Budget Project*

Dr. Michael Dardia, Vice President, SPHERE Institute*

Mr. Bill Heir, Deputy, Legislative Counsel's Office

* Written materials presented by the individual is contain in the yellow pages at the end of this report.

Speaking During Public Comment Period:

Terry Brennan, Service Employees International Union

Dave Doerr, California Taxpayers Association

Chris Micheli, Carpenter Snodgrass

INFORMATION PRESENTED

The hearing consisted of four main parts, which were presented in the following order: 1) An introduction to TEPs and TEP reporting provided by representatives of the Legislative Analyst's Office (LAO) and Department of Finance (DOF); 2) A discussion of the measurement techniques available for use in evaluating TEPs presented by representatives of the Franchise Tax Board (FTB) and Board of Equalization (BOE); 3) A discussion of the ways in which TEP evaluations should be performed, how they should be used, and the role they should play in the budget process; and 4) A summary of the vote requirements that pertain to TEPs.

Testimony presented during the first two segments of the hearing closely paralleled information contained in the background paper. Witnesses representing the LAO and DOF discussed the number and types of existing TEPs and the ways in which both organizations classify and report on TEPs. Witnesses representing BOE and FTB focused on the observation that information required to estimate the economic impact of existing or proposed new TEPs is often unavailable to the agencies responsible for estimating these impacts. Representatives from BOE and FTB also commented on the trade-offs between the cost of data collection (to both the reporting party and the receiving agency alike) and the value of the information obtained. Both witnesses stressed that asking taxpayers to provide information about their utilization of TEPs without imposing penalties for failure to provide that information will yield data that is incomplete and unrepresentative, and therefore inadequate for use in performing TEP evaluations.

The witnesses who provided testimony during the third and fourth parts of the hearing offered a number of different and sometimes conflicting viewpoints. Some of the key subjects discussed included the following:



Use of TEP Evaluations As Part of the Budget Process: All of the speakers agreed that TEP evaluations were an important and valuable tool for use by the Legislature, both in good and bad economic times. However, there were differing views as to when these evaluations should be performed and how they should be used. For example:

- Fred Silva encouraged the Legislature to consider TEP evaluations outside the budget process. He reasoned that enacting legislation asking the Budget Committees to formally consider TEP evaluations would assign them a role they have not had in the recent past. He noted that the Revenue and Taxation Committees and the Appropriations Committees are used to dealing with tax policy; in contrast, the Budget Committees are used to dealing with expenditure policy. For that reason, he suggested the following scenario: 1) Have the LAO perform targeted TEP evaluations on an annual basis and report its findings to the Revenue and Taxation Committees during interim; 2) Have the Revenue and Taxation Committees, in conjunction with the Appropriations Committees and/or the Budget Committees, use the LAO's findings to study a single tax area in depth (e.g., income, sales and use); and 3) Turn the results of this interim study into one or more pieces of legislation that are introduced in January or February and sponsored by the policy and fiscal committees.
- Greg Turner asserted that TEP evaluations should not be considered as part of the budget process, for both credibility and stability reasons. On the issue of credibility, he commented that TEP evaluations have been associated with tax increases. Because of this, tying TEP evaluations into the annual budget process puts the credibility of the reasons for doing the analysis in question. He recommended doing TEP evaluations separate from the budget process.

On the issue of stability, Mr. Turner noted that if the Legislature enacts a TEP to incentivize business behavior or stimulate economic activity, the Legislature must also acknowledge that business' planning horizons can be quite long. For that reason, TEP evaluations should not be used to turn TEPs on and off on an annual basis. TEPs must be in place long enough for their effects to be seen.

- Lenny Goldberg and Jean Ross both agreed that AB 990 (Ridley-Thomas), which would require the Budget Committees to annually examine TEPs as part of the budget process, is a good first step. However, they encouraged the Legislature to include sunset dates on all TEPs and require evaluations for all TEPs. They asserted that doing so will force the Legislature to re-examine TEPs on a periodic basis, with or without AB 990. Each witness had a specific suggestion for amending AB 990. Mr. Goldberg suggested that the evaluation required by AB 990 be given to a budget subcommittee to perform. Ms. Ross suggested that AB 990 be amended to require the budget committee to additionally consider the existence of federal programs as part of their evaluations. She suggested that the effectiveness of certain state programs can be increased if there is already a federal program in existence with the

same goal.

Suggestions For Maximizing the Usefulness of Tax Expenditure Evaluations: Several speakers noted that the quality of available data and the somewhat unclear goals of many TEPs yielded TEP evaluations with widely differing conclusions. A few of the speakers offered suggestions for ways in which to maximize the usefulness of TEP evaluations.

- Jean Ross suggested the following: 1) Establish goals for each TEP when it is proposed; do not determine the goals of a TEP after it has been authorized; 2) Build in data gathering at the outset; 3) Make sure that the TEP is capable of having a causal relationship with the outcome you're trying to achieve; 4) Pay close attention to answer the question of whether the outcome could have occurred in the absence of the TEP; 5) Identify who should perform policy oversight at the outset; and 6) Ask whether money that will be foregone by the state as a result of the TEP is the highest and best value for that money.
- Michael Dardia suggested that the following questions be asked about any TEP intended to incentivize economic activity before it is enacted: 1) What is the main policy goal? 2) What industries are being targeted? 3) What will the utilization rate be? 4) What is the approximate cost? 5) What behavioral changes can be expected (including unintentional effects)?

Dr. Dardia stressed that researchers interested in determining whether a particular TEP achieved its goals must look at the businesses which claimed the TEP, not at the entire industry. Evaluations should also sort out short-run versus long-run responses and direct versus indirect economic impacts.

Vote Requirements:

- Bill Heir provided some interesting historical background regarding the history of current vote requirements. He noted that prior to 1976, the vote requirements needed to increase taxes were not uniform. A 2/3rds vote was required to increase corporation and insurance taxes, while other taxes could be increased with simple majority votes. In 1976, the law was changed to require a simple majority vote to increase all types of state taxes. In 1978, the existing vote requirement regime for state taxes was enacted through voter approval of Proposition 13 (found in the California Constitution, Article XIII A). Under the existing regime, changes in state tax that increase state revenues require a 2/3rds vote of the Legislature. Changes in state tax to decrease state revenues or make no change in state revenues require a simple majority vote.

Mr. Heir noted that the Legislative Counsel has traditionally interpreted Article XIII A as applying to bills in their entirety, not to individual provisions within bills. Thus, if a single bill contains tax provisions that increase state revenue and other tax provisions that decrease state revenue, the Legislative Counsel believes that their fiscal impacts should be netted before applying Article XIII A. When evaluating

revenue estimates, the Legislative Counsel pays more attention to those for initial years, because they are considered less speculative than those for out years.

- Almost all of the speakers noted the challenges posed by existing vote requirement rules. There was general consensus that vote requirements, not lack of TEP evaluations, are the reason that so few TEPs have been repealed.

Diverse Viewpoints Yield Different Conclusions: Commentary during both the latter half of the hearing and the public comment period highlighted the fact that regardless of who performs TEP evaluations, what data are studied, and when and how TEP evaluations are used, different individuals and groups will continue to hold very different ideas about the effect of TEPs on California's economy. For example, Terry Brennan representing the Service Employees International Union noted that TEPs are inefficient when compared with direct subsidies, are inequitable, interfere with the marketplace, and increase the complexity of the tax code. Speaking immediately after Mr. Brennan, Dave Doerr asserted that TEPs are not inefficient with respect to direct subsidies, because TEPs can leverage private investment in ways that direct subsidies cannot.

Another example of diverging viewpoints was expressed by Michael Dardia and Jean Ross. Ms. Ross asserted that the Manufacturers Investment Credit (MIC) worked to reduce manufacturing employment, because it encouraged investment in efficient equipment that could replace workers. Dr. Dardia countered that the more efficient equipment whose purchase is incentivized by the MIC stimulates job creation, because the equipment requires more highly trained workers for its operation.

These disagreements are unlikely to be resolved by TEP evaluations, regardless of the quality of the studies. Although TEP evaluations can inform decisionmakers, preconceived beliefs about the role of government and the way in which the economy reacts to government action will always play a key role in decisionmaking.